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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 693

FEDERAL POWER COMMISSION, PETITIONER

v.

M. H. MARR, SUN OIL COMPANY, CONTINENTAL OIL COMPANY, GENERAL CRUDE OIL COMPANY, TEXAS EASTERN TRANSMISSION CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit (R. 1278–1289) is reported at 336 F. 2d 320. The opinion and orders of the Federal Power Commission (R. 962–984, 1223–1233) are reported at 29 FPC 249 and 30 FPC 153.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on August 3, 1964 (R. 1289–1291). By order of Mr. Justice Black, dated November 2, 1964, the time for filing a petition for a writ of certiorari was extended to November 16,

1964 (R. 1291–1292). The petition was filed on that date and certiorari was granted on January 18, 1965 (R. 1293). The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether the sale of a leasehold interest in proven natural gas reserves to an interstate pipeline company for use by the pipeline in supplying its interstate markets constitutes a sale of "natural gas" subject to the jurisdiction of the Federal Power Commission.

STATUTE INVOLVED

The Natural Gas Act, 52 Stat. 821, as amended, 15 U.S.C. 717–717w, provides in pertinent part:

Section 1(b):

> The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

* * * * *

Section 7(b):

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service ren-

dered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

Section 7(c):

No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: *Provided, however,* That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective date of this amendatory Act, over the route or routes or within the area for which application is made and has so operated since that time, the Commission shall issue such certificate without requiring further proof that public convenience and necessity will be served by such operation, and without further proceedings, if application for such certificate is made to the Commission within ninety days after the effective date of this amendatory Act. Pending the determination of any such applica-

tion, the continuance of such operation shall be lawful.

* * * * *

Section 7(e):

Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is, or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.

STATEMENT

This case involves the jurisdictional status, under Section 1(b) of the Natural Gas Act, of a sale of proven natural gas reserves in the Rayne Field in Louisiana to Texas Eastern Transmission Corporation, a pipeline, for use in supplying the pipeline's interstate markets. It arises out of Texas Eastern's application for a certificate of public convenience and

necessity, pursuant to Section 7 (c) and (e) of the Act, for facilities required to transport the gas from Rayne Field to points on the interstate pipeline system.

The Factual Background.—On February 1, 1957, Texas Eastern, which has an interstate natural gas transmission system extending from Texas to the Philadelphia-Newark area, executed conventional gas sales contracts, for primary terms of twenty years, with Continental Oil Company, Sun Oil Company, M. H. Marr, and General Crude Oil Company to purchase their natural gas production in the Rayne Field at an initial price of 23.9 cents per Mcf, including 1.3 cents per Mcf for reimbursement of State taxes. In April 1957, Texas Eastern applied for a certificate authorizing it to construct and operate a compressor station and pipeline needed to transport the gas from that field to Opelousas, Louisiana, where the gas was to be delivered into the existing pipeline system. At about the same time, the producers applied for certificates authorizing them to sell their gas to Texas Eastern. After a hearing, and despite objections to the 23.9 cent price by the Commission's staff and a number of intervenors, the examiner issued a decision on April 15, 1958, proposing to grant unconditional certificates to each of the applicants (R. 367–405).

On June 30, 1958, before the Commission had acted on exceptions to the examiner's decision, the Court of Appeals for the Third Circuit, in *Public Service Commission of New York* v. *Federal Power Commission,* 257 F. 2d 717, affirmed *sub nom. Atlantic Refining Co.* v. *Public Service Commission of New York,* 360 U.S.

378 (the "*Catco*" case), set aside an order of the Commission granting unconditional certificates for sales of gas from offshore Louisiana at 22.4 cents per Mcf (including a one cent tax reimbursement)—a figure 1.5 cents lower than the price to be charged Texas Eastern—on the ground that the price had not been justified.

Within a month after the court of appeals' decision in *Catco,* producers Sun, General Crude and Marr cancelled their original contracts with Texas Eastern and requested Commission approval for withdrawal of their certificate applications (R. 406–410).[1] In September 1958, Texas Eastern filed a petition to reopen the hearing and to amend its application (R. 412, 440).

The parties then formulated a new plan under which Texas Eastern was to construct essentially the same facilities as those previously proposed and was to receive into its interstate pipeline system the same volumes of gas (R. 965). The only difference was that Texas Eastern now agreed to acquire leasehold interests in the reserves which the producers had formerly committed to standard gas purchase contracts with Texas Eastern.

To effectuate the plan, the four Rayne Field producers or leasehold owners—Continental, Sun, Marr and General Crude—on December 4, 1958 entered into a contract (designated "Lease Sale Agreement") with Louisiana Gas Corporation, an intermediary created

[1] The contracts had permitted the producers to terminate their agreements since September 1, 1957 (*e.g.*, R. 103, 409).

for this transaction (R. 87, 965).[2] By a concurrent agreement Louisiana Gas gave Texas Eastern the right to acquire its title to the "Lease Sale Agreement." Consequently, Texas Eastern has been treated throughout this litigation as the real purchaser (R. 97, 965).

Under this agreement, the producers conveyed their leasehold rights to gas down to the base of the Nodosaria "A" Sand at a depth of from 13,650 to 13,980 feet, together with wells and related equipment, but reserved their "leasehold rights to the oil and other minerals, except gas and condensate," as well as to the gas and condensate below the Nodosaria "A" Sand (R. 186–188). While the agreement in terms conveyed the liquids or "condensate" to be extracted from the gas,[3] it also provided that the producers would receive as "production payments"[4] all proceeds from the sale of the condensate in excess of

[2] The officers of Louisiana Gas, referred to as an affiliate of Texas Eastern by the Commission (R. 965), were members of a law firm which represents Texas Eastern on a retainer basis. The capitalization of Louisiana Gas is $5,000, which was furnished by Texas Eastern without any note of indebtedness. (Tr. pp. 1555–1558.)

[3] Condensate is defined in the agreement as certain liquid and liquefiable hydrocarbons contained in the gas stream (R. 185).

[4] It was explained (R. 79) that a production payment is a type of security or retained interest frequently used in connection with loans of money under which repayment is to be made solely out of the hydrocarbons produced from the property when and as produced. No other personal responsibility is assumed by the borrower.

the costs of operating the leasehold and of processing expenses (R. 188–191).[5]

The lease sale agreement between the producers-assignors and Texas Eastern was executed with the understanding (R. 828–829) that Continental, which had previously operated the field for itself and the other producers, would continue to conduct all operations, including drilling, developing and managing the wells and well equipment. A "Management Agreement" so providing was signed on July 27, 1959 (R. 827–858).

Consideration for the conveyance was $134,395,700, of which $12,420,500 was paid in cash and the balance in promissory notes payable in sixteen annual installments (ending in 1975). If, at Texas Eastern's nomination, gas production exceeds a specified amount, payment of the notes is to be accelerated (in inverse order of maturity) in accordance with a prescribed formula (R. 350–351).

Although the exact amount of the recoverable reserves in the Rayne Field was a matter of controversy, they are admittedly substantial; Texas Eastern's estimate exceeds 900,000,000 Mcf (R. 966).

The lease sale agreement was expressly conditioned upon the issuance by the Federal Power Commission of certificates of public convenience and necessity authorizing the construction and operation of facili-

[5] The condensate is, in fact, being sold by Texas Eastern to the producers under long-term contracts which terminate when the production payments terminate. Thus, the producers buy the condensate and receive the net proceeds therefrom while Texas Eastern retains none of the net proceeds from its sale (R. 582–587).

ties required to take gas from Rayne Field and to transport it to the market area. Upon the issuance of certificates satisfactory to each party, the gas purchase contracts of February 1957 were to be cancelled (R. 173–175).[6]

First Proceedings on Lease Sale Plan.—The Commission granted Texas Eastern's request (*supra*, p. 6) to reopen the proceeding in order to consider the lease sale plan and, on June 23, 1959, issued an unconditional certificate to Texas Eastern for its proposed facilities. In issuing the certificate, the Commission overruled the objection of the New York Public Service Commission that the record did not adequately disclose the costs of the leases to Texas Eastern, a showing which, in New York's view, required evidence of the costs of the producers.

On July 23, 1959, the New York Commission applied for rehearing (R. 467). Four days later, the transfer of the gas rights under the leases was completed and Texas Eastern began to receive gas from Rayne Field (R. 888)—gas which it has since transmitted and sold at wholesale in interstate commerce. Subsequently, the Commission denied rehearing (R. 476). On review, however, the Court of Appeals for the District of Columbia Circuit set aside the certificate order and remanded the case for further proceedings. *Public Service Commission of New York* v. *Federal Power Commission*, 287 F. 2d 143 (R. 862–868). The

[6] The sellers, with the exception of Continental, had purportedly cancelled their contracts months prior to the execution of the lease sale agreement on December 4, 1958. See *supra*, p. 6.

court held that, without substantial evidentiary support, "the language and the tenor of the [Power] Commission's Opinion and Order appear to confer general approval upon the terms of the acquisition arrangement" (R. 865, 287 F. 2d at 145). On the assumption that the Commission had no jurisdiction over the lease sale, the court held that, regardless of the form of the transaction, the Commission was, at some time, required to consider fully the reasonableness of the acquisition costs to the pipeline (R. 866–867, 287 F. 2d at 146).

The Proceedings on Remand.—On remand, the Commission reopened the proceeding. It afforded Texas Eastern an opportunity to show the reasonableness of its acquisition costs but did not limit the proceeding to that issue. In his decision, the examiner found that it was "virtually impossible, from the record, to determine the future costs to Texas Eastern for the Rayne Field since they are predicated upon assumptions and estimates" (R. 891–892). Nonetheless, he arrived at the conclusion that "when all [Texas Eastern's] costs, and estimated costs, are computed, the average cost becomes 24.34¢ per Mcf at 15.025 psia" (R. 896). Finding that this price was out of line and that the "in-line" price was 18.5¢ per Mcf (R. 897), he held that Texas Eastern should be granted a certificate conditioned upon the inclusion of the Rayne Field gas in the pipeline's cost of service at an initial price of 18.5¢ per Mcf (exclusive of taxes) and on its maintenance of supplemental accounts providing "summary and detailed data respect-

ing the cost of the Rayne Field gas to Texas Eastern" (R. 897-898).

While noting that the Commission's staff and one of the intervenors "vigorously contend in their briefs the Commission does have jurisdiction over such [Rayne Field Lease] acquisitions" (R. 885), the examiner held that the Commission was without jurisdiction "until (1) the gas was connected to an interstate system of pipelines or (2) the gas was dedicated to a sale in interstate commerce" (R. 887).

The Commission,[7] on exceptions, concluded that the jurisdictional issue was not foreclosed by its earlier action in the case, and held that the transfer of gas to Texas Eastern constituted a sale in interstate commerce for resale, whether technically in the form of a leasehold transaction or otherwise.[8] It reasoned that the "fact that the gas, which had been developed to an extent where reasonable estimates could be made as to available reserves," though in form a transfer of leasehold right plus equipment, closely resembled, in practical effect, the ordinary sale of gas. In this connection, it found (R. 973):

> (1) Only gas in particular strata is conveyed; and the producers retain their interest in oil and other minerals;
>
> (2) In effect the transaction is for the sale of stripped gas inasmuch as the producers are

[7] Commissioner Woodward, who did not participate in the original order and opinion, wrote a dissenting opinion to the order on rehearing.

[8] The Commission expressly refrained from dealing with either the transfer of other property rights or the operation of the producing properties, wells or the equipment used for production and gathering (R. 972).

to receive a production payment from Texas Eastern from the sale of natural gas liquids;

(3) While the payment for the leases is represented by notes and spread over a 16-year period, the notes have an acceleration clause by which payment is accelerated if production is increased, so that Texas Eastern's payments would be geared to production;

(4) By a management agreement dated July 27, 1959, Continental agrees to operate the field, including drilling wells and managing all wells and equipment, and to deliver to Texas Eastern specified minimum daily quantities of gas; Texas Eastern will reimburse Continental for its expenses in operating the field but the assignment of the leases shows that the costs of operating the leases will be defrayed out of the production payments to which Continental is entitled;

(5) It is Louisiana Gas, not Texas Eastern which is liable on the notes to the producers, so that the true purchaser of the gas [is] not bound by the principal obligation of the lease sale transaction.

Having decided that it had jurisdiction over the "in-place" sale of the Rayne Field gas reserves, the Commission concluded that it was not in the public interest to certificate the present transaction. It was not satisfied that the unit cost of the gas was reasonable or that it could be determined with reasonable accuracy. Rather than deny outright Texas Eastern's application, the Commission afforded it and the sellers an opportunity to revise their contractual arrangements so as to furnish assurance that the transactions,

already partially consummated would be consistent with the public interest (R. 978–979, 1228–1229).

The Court of Appeals for the Fifth Circuit set aside the Commission order, holding that the contracts transferred not only rights to gas, but also rights to wells and related production equipment and rights of ingress and egress. Reasoning that "these transfers were 'leases' as that term was used" in *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, it concluded that the transaction was beyond the Commission's jurisdiction.[9] In reaching this result, it also construed this Court's decision in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, as limited to sales made after "production and gathering" had ended (R. 1287).[10]

[9] In view of its disposition of the case, the court found it unnecessary to reach the contention of petitioners below that the Commission was barred from considering its jurisdiction over the transaction as producer sales because the Court of Appeals for the District of Columbia had disposed of the earlier appeal on the basis of the absence of Commission jurisdiction over the sale as such.

[10] Since the decision below, the Tenth Circuit, in setting aside another Commission determination of jurisdiction with respect to a similar lease sale transaction, concluded (1) that the conveyance was not a sale of gas and (2) that the transfer was a lease and hence exempt. *Pan American Petroleum Corp.* v. *Federal Power Commission*, 339 F. 2d 694, setting aside in part *Tennessee Gas Transmission Co.*, 30 FPC 1477. Unlike the Fifth Circuit, the court did not construe *Phillips* as relating to less than all sales at wholesale.

The Commission is petitioning for certiorari in that case.

766-842—65——3

SUMMARY OF ARGUMENT

1. Section 1(b) of the Natural Gas Act gives the Federal Power Commission jurisdiction over "the sale in interstate commerce of natural gas for resale," but excepts "the production or gathering of natural gas." In *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672, 685, the affirmative grant of jurisdiction was held to cover all sales at wholesale of natural gas in interstate commerce, whether by a pipeline or by an independent producer, and whether occurring before, during, or after transmission in interstate commerce. The question here is whether the Commission was warranted in treating the sale in question, although it was in form a transfer of an interest in real property (the sale of a leasehold), as constituting in substance a sale of gas for purposes of the Natural Gas Act.

That question depends, not upon the law of conveyancing, but upon the economic reality of what the parties have done. Cf. *California* v. *Lo-Vaca Gathering Co.,* No. 46, this Term. Moreover, the expert agency chosen to administer the statute has considerable room for judgment in giving concrete meaning and content to the statutory terms. *Gray* v. *Powell,* 314 U.S. 402, 413; *National Labor Relations Board* v. *Hearst Publications,* 322 U.S. 111, 131. In the present case, the elements which marked this transaction as essentially a sale of gas, at least from the standpoint of the objectives of the regulatory statute, are so pronounced as to leave no serious question that the Commission was well within the bounds of its authority.

In substance, a group of producing companies transferred to Texas Eastern, an interstate pipeline company, their right to take all of the gas suitable

for pipeline use from a proven, substantial, and well defined body of gas reserves—a body of reserves from which the gas was ready to flow upon the turn of a valve and from which it has in fact been flowing in interstate commerce from the date of the acquisition. In terms of practical effects and regulatory objectives, the transaction is essentially the same as a conventional sale at the wellhead; and it is not disputed that all of the gas is destined for use in supplying the pipeline's markets in States other than Louisiana.

Such differences as here may be between an "in-place" sale of gas and a wellhead sale do not require a difference in regulatory treatment. In all events, those differences are minimized in the present case by special provisions of contract—provisions calculated to change the form of the arrangement and to avoid price regulation, but otherwise to give the parties the same essential bargain that they had under their prior conventional agreement of sale.

2. If the transaction involved here was a sale in interstate commerce of gas for resale, it follows, under the authorities, that it is not within the exemption provided by Section 1(b) for "production or gathering." *Phillips Petroleum Co.* v. *Wisconsin, supra; Saturn Oil & Gas Co.* v. *Federal Power Commission,* 250 F. 2d 61, 68 (C.A. 10), certiorari denied, 355 U.S. 956. The decision below rests, in part at least, upon the erroneous premise that a sale of natural gas cannot be jurisdictional if it takes place before the production and gathering processes have run their course. This view is based upon a misin-

terpretation of the *Phillips* decision; was impliedly rejected by this Court in *Cities Service Gas Co.* v. *State Corporation Commission of Kansas,* 355 U.S. 391; and is contrary to prior court of appeals decisions.

The concepts of a "sale for resale" and that of "production or gathering" do not mark out mutually exclusive territories: a sale may occur before production or gathering is completed. The two statutory concepts can be reconciled by adopting the entirely plausible interpretation that the exemption relates to the facilities and processes involved in production or gathering, but not to sales of the kind affirmatively subjected to Commission jurisdiction, whatever the stage at which those sales occur.

The Fifth Circuit's reliance on *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, is misplaced. That case involved a quite different issue—namely, whether an interstate pipeline could, without the Commission's authorization, make any disposition whatever of undeveloped leases and reserves which had been included in its rate base and which it had relied upon to support its applications for certificates of public convenience and necessity. The Court had no occasion to consider the question presented here—*i.e.,* whether a transfer of proven reserves is tantamount to a "sale of natural gas"—since the gas to be produced from Panhandle's transferred leases was in no event intended for resale "in interstate commerce," but was to be consumed within the producing State.

3. We show, finally, that the decision below would provide a simple mechanism for avoiding effective regulation, State or federal. The present sale, involving reserves estimated at nearly a billion Mcf, is by no means an isolated example of attempts to use the device of an "in-place" sale to avoid effective Commission regulation of the price at which gas is purchased for the interstate market. If such sales were not subject to direct Commission regulation, an "attractive" and, we apprehend, ever-widening gap in the "regulatory system" would be created. Cf., *Lo-Vaca, supra; Federal Power Commission* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1.

ARGUMENT

I. A SALE OF LEASEHOLD INTERESTS IN PROVEN RESERVES IS A SALE OF "NATURAL GAS" WITHIN THE MEANING OF SECTION 1(b) OF THE ACT AND THEREFORE SUBJECT TO COMMISSION JURISDICTION

Section 1(b) of the Natural Gas Act, *supra*, p. 2, gives the Federal Power Commission jurisdiction over "the sale in interstate commerce of natural gas for resale," but specifically excepts "the production or gathering of natural gas." In *Phillips Petroleum* v. *Wisconsin*, 347 U.S. 672, 685, the affirmative grant of jurisdiction was held to cover all sales at wholesale of natural gas in interstate commerce, whether by a pipeline or by an independent producer, and whether occurring before, during, or after transmission in interstate commerce. In reaching this conclusion, the Court emphasized (347 U.S. at 685) that the rates charged by an independent producer "may have a

direct and substantial effect on the price paid by the ultimate consumers" and that "[p]rotection of consumers against exploitation at the hands of natural-gas companies was the primary aim of the Natural Gas Act."

The question here is whether the Commission was warranted in treating the sale in question, although it was in form the transfer of an interest in real property (the sale of a leasehold), as constituting in substance a sale of gas for purposes of the Natural Gas Act.[11]

We start with the proposition that the question whether this transaction was a "sale" of "natural gas" within the meaning of this Act depends not upon the law of conveyancing, but upon the economic reality of what the parties have done. Earlier this Term, the Court had occasion to reiterate, in a different though related context, that the Commission's jurisdiction under the Gas Act turns upon the actualities and is not governed by artificial contractual provisions. *California* v. *Lo-Vaca Gathering Co.*, No. 46, this Term, decided January 18, 1965. So, too, in the present case one must examine the practical incidents of the transaction in light of the overriding objectives of the Act in order to determine whether it comes within the statutory terms. The fact that State conveyancing law may regard it as a transfer of real

[11] If the transaction constitutes a sale of gas within the Commission's jurisdiction for which approval has not been sought and obtained, it follows, of course, that the Commission properly denied, as not within the public convenience and necessity, an application for authority to construct facilities designed solely for the purpose of carrying that gas.

property interests is not controlling. To hold otherwise would not only exalt form over substance, but would make the scope of the Commission's authority dependent upon the vagaries of State law, something this Court has repeatedly refused to do. *E.g., Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672, 681.

We note further that the expert agency chosen to administer the statute has considerable room for judgment in giving concrete meaning and content to the statutory terms. In a case arising under the Bituminous Coal Act, this Court stated (*Gray* v. *Powell,* 314 U.S. 402, 413):

> Unless we can say that a set of circumstances deemed by the Commission to bring them within the concept 'producer' is so unrelated to the tasks entrusted by Congress to the Commission as in effect to deny a sensible exercise of judgment, it is the Court's duty to leave the Commission's judgment undisturbed.

Similarly in *National Labor Relations Board* v. *Hearst Publications,* 322 U.S. 111, 131, the Court held that the agency's "determination that specified persons are 'employees' under this Act is to be accepted if it has 'warrant in the record' and a reasonable basis in law." See, also, *United States* v. *Drum,* 368 U.S. 370; *National Labor Relations Board* v. *Coca Cola Bottling Co.,* 350 U.S. 264. Certainly, no less deference is due a determination by the Power Commission that a transaction is to be regarded as a sale of gas for purposes of the Natural Gas Act.

In all such situations one may postulate "innumerable variations that bring the arrangements closer to one pole or the other of the range between exemption and inclusion" (*Gray* v. *Powell, supra,* at 413). Here.

however, the elements which mark this as essentially a sale of gas, at least from the standpoint of the objectives of the regulatory statute, are so pronounced that there can be no serious question, we submit, that the Commission was well within the bounds of its authority.

A group of independent producing companies sold to Texas Eastern, an interstate pipeline company, part of their working or leasehold interests in certain substantially developed gas properties. In practical terms, they transferred their right to take all of the gas suitable for pipeline purposes from a proven, substantial, and well defined body of gas reserves—a body of reserves from which the gas was ready to flow upon the turn of a valve and from which it has in fact been flowing in interstate commerce from the date of the acquisition (R. 554). However the transaction may be viewed under the law of conveyancing, the interest of Texas Eastern was in making a direct acquisition of a huge block of deliverable gas for use in its lines. The fact that it bought this deliverable gas in the ground or "in place", rather than at the wellhead (as it had earlier contracted to do), is of little significance either from the standpoint of the operation of the pipeline or the protection of the consumer.[12]

[12] As respondents point out (*e.g.*, Br. in Opp. p. 16; R. 1023, 1039), Louisiana mineral law does not recognize the ownership of gas in place. But many other producing States, including Texas and Kansas, do recognize ownership and hence sale of gas in place. See, *e.g.*, *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, 375; *Burnet* v. *Harmel*, 287 U.S. 103, 109; 1 Williams and Meyers, *Oil and Gas Law* (1964 ed.), pp. 26–47. In any event, jurisdiction under the Natural Gas Act does not depend on the vagaries of State law. *E.g.*, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 681.

We emphasize that this is not a case in which a speculator or wildcatter bought an interest in property for the purpose of engaging in exploration.[13] The supply was proven and the gas was ready to flow. Moreover, since the purchaser was an interstate pipeline, it is clear that its primary interest was in obtaining gas, rather than other minerals. And it is undisputed that all of the gas is destined for States other than Louisiana.

Without more, we submit, this was enough to establish that the Commission's judgment was permissible, if not required. It may be suggested that there are material differences between the transaction in this case and the conventional gas sale, *i.e.*, a sale at the wellhead on a unit or Mcf basis. However, a more detailed analysis of the two types of transactions, far from dictating a result contrary to that reached by the Commission, adds further support for its conclusion. For the similarities outweigh the differences.

In the case of a conventional sale, the pipeline agrees to take specified volumes for a prescribed period of time (usually twenty years or more) at a stated price per unit, while the producer, by "dedicat-

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[13] The Commission has had no occasion to decide whether it would have jurisdiction over a sale of leases where anticipated reserves have not been proven or developed. Here, also, we put that question to one side.

ing" a defined body of reserves to the particular sale, surrenders his right to dispose of those reserves elsewhere."[14] In the type of transaction involved here, the producer, instead of "dedicating" his reserves, transfers his interest in them to the pipeline company in return for an immediate lump sum payment plus a promise to make additional payments annually, and the pipeline is then free to draw upon those reserves so long as it continues to meet its periodic obligations. In both cases, the pipeline commits itself to pay a specified sum of money over a given period of time in return for a right to take gas from a defined block of reserves, while the producer gives up the right to sell those reserves to any other buyer.

The ready interchangeability of the two forms of arrangement is dramatically illustrated by the circumstances of this case. As we have shown (*supra*, pp. 5–6), the lease sale agreements were substituted for the prior wellhead sales only after the Third Circuit had set aside the Commission's order granting unconditional certificates for the somewhat lower priced, but otherwise comparable, sales involved in *Catco*. The new arrangement contemplated the construction of the same facilities and the receipt by Texas Eastern of the same volumes of gas, presumably at ap-

[14] Dedication of reserves occurs as soon as deliveries commence (*e.g.*, *Atlantic Refining Co.* v. *New York Public Service Commission*, 360 U.S. 378, 387–389). Once service has commenced, a producer can terminate deliveries from the specified reserves only after having received Commission approval, normally pursuant to Section 7(b), regardless of the term of its contract. *Sunray Mid-Continent Oil Company* v. *Federal Power Commission*, 364 U.S. 137.

proximately the same price, as envisioned by the earlier sale.

The typical differences between the two forms of transaction are not important enough to justify a difference in regulatory treatment; and in any event they are minimized in the present case by special contract provisions.

In the standard wellhead sale, to be sure, the pipeline buys nothing but natural gas, whereas most leasehold sales involve the transfer of other mineral rights as well.[15] While we do not believe the presence of other elements should preclude regulation of the transfer insofar as it involves gas (where the gas is transferred to a pipeline company for interstate commerce), in this case the agreement expressly excludes all interests in minerals other than gas. And inasmuch as the interests conveyed are limited to the developed gas reserves, *i.e.*, gas above the base of the Nodosaria "A" Sand at a depth of 13,650' to 13,890 feet, the sellers also retain the right to explore for and produce any gas there may be at greater depths. Moreover, while Texas Eastern becomes the titular owner of the liquid hydrocarbons, or condensates, that may be separated or extracted from the gas after it is withdrawn from the ground, the terms of the agreement give the sellers the economic benefit of those liquids. For, in addition to the $134,395,700 consid-

[15] However, it is by no means unusual for one who is admittedly a purchaser of gas at the wellhead to obtain the right to extract liquefiable hydrocarbons. See, *e.g.*, *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission*, 290 F. 2d 552 (C.A. 10).

eration, Texas Eastern must make periodic "production payments" which are equivalent, in effect, to the net proceeds from the sale of the liquids stripped from the gas (R. 188–193, 583–587).[16]

A second difference between a conventional sale at the wellhead and a sale of reserves "in place" is that the sale "in place" may shift to the pipeline purchaser the responsibility of bringing the gas out of the ground, whereas in the conventional arrangement this work is ordinarily performed by the seller. The difference, we think, is unimportant. The principal economic function of an independent producer is to seek out and to develop new reserves; once that is done the operation of going wells is relatively minor and routine activity, in terms of both cost and effort. Even in the standard purchase arrangement, this final step in production is sometimes assigned to the pipeline purchaser. See, *e.g.*, ***Continental Oil Co.* v. *Federal Power Commission***, 266 F. 2d 208 (C.A. 5), certiorari denied, 361 U.S. 827. The point does not arise in the present case, however, because any difference has been all but

[16] It was contemplated that the condensate liquids—*i.e.*, liquid hydrocarbons at the surface which existed in gaseous state in the original condition or reservoir pressure and temperature—would be removed from the gas stream both by mechanical separation in the field and at an extraction plant (R. 185, 188–193).

The production payments are to cease at the time of payment of the last scheduled note, *i.e.*, 1975 (R. 587) and Texas Eastern anticipates obtaining liquid revenues thereafter. It should be pointed out, however, that a lease conveyance could readily be written to reserve to the seller a production payment for the life of the field.

obliterated by the provisions in the contract which assign to one of the producers, Continental, the task of drilling, developing and managing the wells. The costs of operation, including Continental's management fee for performing that work, are to be borne by the producer-sellers much as if they retained the function. For while Texas Eastern, the pipeline, is obligated to reimburse Continental in the first instance (R. 835), Texas Eastern recovers the outlay from the proceeds from the condensates before remitting the balance to the producers as a production payment (R. 188–190, 973).

A third difference between a conventional sale of gas at the wellhead and a transfer of reserves in place may sometimes be found in the allocation of the risk of premature exhaustion of the reserves and the benefit of unexpected abundance. In the absence of any contrary stipulation, the risk falls upon the lessee so that the sale of a leasehold interest would shift the uncertainty to the pipeline purchaser: The latter agrees to pay a fixed price for the entire body of reserves, loses if they are less than predicted and gains if they are more; its outlay per unit of production would therefore depend upon whether the reserves exceeded or fell short of expectations. We submit that this is, at most, a factor to be weighed by the Commission in the particular case. The degree of risk and therefore its relative importance in any given transaction will vary from case to case. When the transferred leases are substantially developed, the risks, though present to some degree, may have negligible importance in relation to other character-

istics of the transaction. It is relatively simple, moreover, to negate any real shifting of the risks by including any one of various contractual stipulations in the agreement for the leasehold sale. In two recent cases, for example, the parties to leasehold sales made provision for later readjustment of the purchase price on the basis of a mid-life redetermination of the reserves. *Tennessee Gas Transmission Co.*, 30 FPC 1477, set aside in part *sub nom. Pan American Petroleum Corp* v. *Federal Power Commission*, 339 F. 2d 694 (C.A. 10), (sales contract provides for one redetermination of reserves upon request of either party between 1969 and 1973); *Continental Oil Co. et al.*, FPC Docket No. RI64-129, Order issued October 23, 1964, and the examiner's decision issued August 19, 1964[17] (redetermination of recoverable reserves to redetermine total price at request of any party in seventh year after signing of agreements).[18] There is,

[17] In that case, the examiner, after finding that the in-place sale should be treated as jurisdictional, concluded nevertheless that he was bound by the Fifth Circuit decision in the present case to hold the transaction non-jurisdictional. The Commission adopted the examiner's decision, except the conclusion that the decision below was controlling in this case.

Petitions to review the Commission's order have been filed in four circuits, *Atlantic Refining Co.* v. *Federal Power Commission*, C.A.D.C. No. 19137; *Continental Oil Co.* v. *Federal Power Commission*, C.A. 5 No. 22163; *Cities Service Oil Co.* v. *Federal Power Commission*, C.A. 10 No. 8024; *Tidewater Oil Co.* v. *Federal Power Commission*, C.A. 9 No. 19835. All of these cases are being held in abeyance pending the decision here.

[18] In this case, relating to the sale of reserves in the Ship Shoal Field, the examiner pointed out that a witness for one of the sellers had "stated that there was a wide variation in the reserve estimates among the parties, that the actual amount of recoverable gas was not and could not have been ascertained, and that the reserve figure was merely an arbitrary one de-

of course, no reason why the contract could not substantially eliminate the uncertainty by providing for several periodic redeterminations of reserves and consequent price adjustments.

In the present case, Texas Eastern apparently accepted a measure of the risk that it had overestimated the reserves—a risk which inheres in the fact that, under the contract, payments "lead" production.[19] But the risk is more apparent than real. Texas Eastern organized an intermediary (Louisiana Gas Corporation) which actually entered into the lease-sale agreement and alone is obligated on the notes to the producer-sellers (*supra*, p. 12). Should the reserves show signs of exhaustion before the end of the payout period, this "shell" corporation could default on the notes and surrender the leases to the producers. Thus, the principal risk—failure or destruction of the reserves at a relatively early date—remains with the producer-sellers.

The fact that the reserves were not measurable with precision at the time of contract,[20] and that the pipeline assumed some of the attendant risk—while it might, as the Commission indicated (R. 976–977), cast doubt upon whether the entire transaction would serve the public convenience and necesssity—does not

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signed to serve only as a base for computing the purchase price adjustment in the event of redetermination of the price" (mimeo. op., p. 3).

[19] If production is increased over the anticipated rate, payment on the notes becomes accelerated (R. 351; *supra*, p. 12).

[20] The lease sale and conveyance expressly excluded from the transfer an interest in gas below a stated depth, *i.e.*, below the area of any development. It thus limited the transfer to reserves which were to some extent measurable and excluded those which could be estimated only by pure guesswork.

remove it from the Commission's jurisdiction. Indeed, the difficulty of determining in advance the exact price per Mcf paid by the pipeline makes it all the more important that the Commission have power to scrutinize the sale and to impose such conditions as may be necessary to minimize the risk to the ultimate consumer (R. 982–983). For jurisdictional purposes, however, the dominant consideration is that what the pipeline paid for was the producers' interest in a defined block of deliverable gas. Both in the economic sense and in terms of the regulatory objective—the protection of the ultimate consumers—there has been a sale of natural gas, even if there has also been a transfer of an interest in real property.

II. A SALE OF LEASEHOLD INTERESTS IN PROVEN RESERVES DOES NOT COME WITHIN THE "PRODUCTION OR GATHERING" EXEMPTION

A. If, as argued above, the transaction involved here was a sale in interstate commerce of gas for resale, it follows, under the authorities, that it is not within the exemption provided by Section 1(b) for "production or gathering." As the Tenth Circuit pointed out in *Saturn Oil & Gas Co.* v. *Federal Power Commission*, 250 F. 2d 61, 68, certiorari denied, 355 U.S. 956, the *Phillips* decision necessarily established "that the production or gathering exemption of Section 1(b) did not apply to exclude from the jurisdiction of the Commission sales by any producer of natural gas for transportation interstate for resale to the public."

The decision below rests, in part at least, upon the erroneous premise that a sale of natural gas cannot be jurisdictional if it takes place before the production and gathering processes have run their course. The court below emphasized that in *Phillips* the Court was "able to find jurisdiction because [quoting this Court's opinion] 'production and gathering, in the sense that those terms are used in Section 1(b), end before the sales by Phillips occur'" (R. 1287). There is no indication in *Phillips*, however, that this circumstance—the prior termination of production and gathering—was essential to this Court's finding of jurisdiction. On the contrary, *Phillips* seems to rest squarely on the view that all sales in interstate commerce for resale are subject to Commission jurisdiction and that it is the "production or gathering" exemption that must yield if necessary to give effect to this affirmative grant of jurisdiction.[21] Thus, re-

[21] Thus, Mr. Justice Douglas stated, in dissenting in *Phillips* (347 U.S. at 688): "There is much to be said from the national point of view for regulating sales at both ends of these interstate pipelines. The power of Congress to do so is unquestioned. Whether it did so by the Natural Gas Act of 1938 is a political and legal controversy that has raged in the Commission and in the Congress for some years. The question is not free from doubts. For while § 1(b) of the Act makes the regulatory provisions applicable 'to the sale in interstate commerce of natural gas for resale for ultimate public consumption,' it also makes them inapplicable 'to the production or gathering of natural gas.'

"The sale by this independent producer is a 'sale in interstate commerce * * * for resale.' It is also an integral part of 'the production or gathering of natural gas,' * * * for it is the end phase of the producing and gathering process. So we must make a choice; and the choice is not an easy one."

jecting (347 U.S. at 680–681) a contention that its earlier decision in *Interstate Natural Gas Co.* v. *Federal Power Commission*, 331 U.S. 682, had rested on narrow distinctions, the Court observed that *Interstate* was based "on the broader ground that sales in interstate commerce for resale by producers to interstate pipeline companies do not come within the 'production or gathering' exemption."[22] Moreover, in terms of what *Phillips* defined as the "primary aim of the Natural Gas Act"—*i.e.*, "[p]rotection of consumers against exploitation at the hands of the natural-gas companies" (347 U.S. at 685)—it is obviously immaterial whether the sale of gas takes place before or after completion of production and gathering. That distinction is equally irrelevant to the "overriding congressional purpose" of plugging "the 'gap' in regulation" over such sales by the States (347 U.S. 682–683).

The Fifth Circuit's restrictive reading of *Phillips* was also impliedly rejected by this Court when it invalidated the Kansas minimum price regulations in *Cities Service Gas Co.* v. *State Corporation Commis-*

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[22] In the *Interstate* case, the Court had similarly observed (331 U.S. at 692–693): "* * * All the gas sold in these transactions is destined for consumption in States other than Louisiana. Unreasonable charges exacted at this stage of the interstate movement become perpetuated in large part in fixed items of costs which must be covered by rates charged subsequent purchasers of the gas, including the ultimate consumer. It was to avoid such situations that the Natural Gas Act was passed. [Quoted in *Phillips*, *supra*, 347 U.S. at 680.]" These objectives could not be achieved by limiting federal regulatory jurisdiction to those instances where production and gathering had been concluded.

sion of Kansas, 355 U.S. 391. That decision, citing *Phillips* and *Natural Gas Pipeline Co.* v. *Panoma Corp.*, 349 U.S. 44, reversed, *per curiam*, a decision of the Kansas Supreme Court (180 Kan. 454, 304 P. 2d 528) upholding (as a valid conservation measure) an administrative order requiring payment of a minimum price before cessation of production. The Kansas Court sought to distinguish *Phillips*, as well as *Panoma* (in which a similar Oklahoma minimum price regulation was struck down), on the ground that in both of those cases the production and gathering process had ended prior to the sale to which federal jurisdiction attached. This Court's reversal necessarily involved a rejection of that view.

Moreover, until the decision below, no court of appeals had interpreted *Phillips* so narrowly. On the contrary, both the Tenth Circuit in *Saturn* and the Fifth Circuit itself in *Deep South Oil Co.* v. *Federal Power Commission*, 247 F. 2d 882, 888–889,[23] have upheld the Commission's jurisdiction over producer sales at the wellhead, even though consummated before the gas had been gathered. In *Saturn*, the court, after pointing out that the case before it was factually different from *Phillips* because the sale in-

[23] In two companion cases in which the opinion in *Deep South* was followed certiorari was denied. *Shell Oil Co.* v. *Federal Power Commission*, 247 F. 2d 900 (C.A. 5), certiorari denied, 355 U.S. 930, and *Humble Oil & Refining Co.* v. *Federal Power Commission*, 247 F. 2d 903 (C.A. 5), certiorari denied, 355 U.S. 930. These orders denying certiorari were issued one week after the *per curiam* order in *Cities Service*, *supra*, p. 30.

volved was made prior to gathering, nevertheless rejected petitioner's "contention that the Act was never intended to apply to wellhead sales because such sales are made during production and gathering and are only technically consummated in interstate commerce." It concluded that in "the final analysis the question resolves itself into a determination of whether the *Phillips* decision is to be viewed in light of its precise facts or in the light of the broad language of the court," and that this Court had carefully refrained from basing *Phillips* on narrow grounds. 250 F. 2d at 64, 67–68. In *Deep South, supra,* the Fifth Circuit similarly held that the Commission had jurisdiction over wellhead sales for resale consummated before the gas had been gathered, noting that the affirmative grant of jurisdiction in Section 1(b) was not limited by the production and gathering exemption. 247 F. 2d at 888–889.[24]

[24] In *Continental Oil Co.* v. *Federal Power Commission*, 266 F. 2d 208 (C.A. 5), certiorari denied, 361 U.S. 827, a related issued was decided. There a sale was made at the top of two valves in the "Christmas Tree" at the wellhead, prior to the completion of gathering. While the jurisdictional character of the sale was not at issue, Continental contended that none of its facilities was jurisdictional. The Commission claimed alternatively that facilities used by the producer to make the sale were not production facilities or else that production facilities which are essential to effect a sale are not exempt facilities. Judge Tuttle, speaking for the majority, stated that under *Phillips* and *Deep South* a strong argument could be made for concluding that production facilities which are also essential to effect a jurisdictional sale would be subject to Commission jurisdiction, notwithstanding the production and gathering exemption. But the court did not decide on that basis, holding instead that the record supported the Commission's conclusion that there were facilities used for the sale of the gas that were not facilities for production.

The short of it is that the concepts of a "sale for resale" and of "production or gathering" do not mark out mutually exclusive territories: a sale may occur before production or gathering is completed. The two statutory concepts can be reconciled by adopting the entirely plausible interpretation that the exemption relates to the facilities and processes involved in production or gathering, but not to sales of the kind affirmatively subjected to Commission jurisdiction, whatever the stage at which those sales occur. That this is the correct resolution is the plain teaching of *Phillips* and the successor cases to which we have referred. It is a resolution, moreover, which in no way interferes with the power of the States to regulate the physical processes of production in the interest of conservation or for other legitimate purposes.

B. The Fifth Circuit's reliance upon *Federal Power Commission* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, is misplaced. Panhandle, an interstate pipeline, sold *undeveloped* leases in the Kansas-Hugoton field to a subsidiary, Hugoton Production Company;[25] the subsidiary in turn developed the leases and sold the gas for industrial use within the State of Kansas (337 U.S. at 500–501). The Commission argued (a) that the power to prevent this disposition was a necessary incident of its general certificate and rate authority over interstate pipelines, and (b) that the leases were jurisdictional facilities which could not

[25] The Hugoton stock was then spun off to Panhandle's stockholders.

be disposed of or abandoned without Commission authorization pursuant to Section 7(b) of the Act. It pointed to the fact that the leases and reserves, though unconnected to the pipeline system, had been relied upon by Panhandle to support its application for certificates to build additional pipeline facilities, and had been included in its rate base as "used and useful property." This Court rejected those contentions, stressing that the leases "are an essential part of production" (337 U.S. at 505), and that "the transfer of undeveloped gas leases is an activity related to the production and gathering of natural gas and beyond the coverage of the Act" (337 U.S. at 515). The Court noted that the rate and certificate provisions invoked by the Commission were in terms limited to matters (*i.e.,* facilities and transportation or sale) "subject to the jurisdiction of the Commission". (Sections 4 (a), (b), (c), 5(a), 7 (b) and (c)), and it refused to read the grant of jurisdiction over "natural-gas companies" in Section 1(b) so broadly as to "swallow all the exceptions of the same section."

It is evident that the issue in *Panhandle* was quite different from the one presented here. There the question was whether, without Commission approval, an interstate pipeline could make any disposition whatever of leases which had been included in its rate base and relied on to support its applications for certificates of public convenience and necessity. Since the gas from Panhandle's transferred leases was to be consumed in the producing State, the Commission was unable to claim that the transfer was a sale "in interstate commerce." Accordingly, this Court had no occasion to consider the question now

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at issue—whether a transfer of proven reserves may be a jurisdictional sale of "natural gas." Nor was it required to examine the relationship between the "production or gathering" exemption and the equally specific affirmative grant of power over sales of natural gas in interstate commerce. The fact that the Court was unwilling to subordinate the exemption to the rather nebulous grant of authority over "natural-gas companies" does not mean that it would have given the exemption similar precedence over the very specific jurisdictional grant which we invoke here.[26]

The *Panhandle* case, moreover, antedated the *Phillips* decision by some five years, and was decided at a time when the Commission had not asserted jurisdiction even over conventional sales of gas by independent producers at the wellhead. The assumption that the Commission lacked control over such sales may well have influenced this Court's thinking in *Panhandle.* For the Court was at pains to explain that in sanctioning the inclusion of production and gathering facilities in a pipeline's rate base, its earlier decision

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[26] Respondents (Br. in Opp., p. 14) seek comfort in the fact that the Commission, in its annual reports to Congress from 1951 through 1962, requested authority to regulate leasehold transfers. In so doing, they overlook the fact that the present issue is not encompassed by the requested legislation, which specifically asks that Section 7(b) of the Gas Act be amended to require Commission approval for the transfer by an interstate natural gas pipeline company of natural gas reserves where such reserves have constituted part of the basis for issuance of certificates of public convenience and necessity. See, *e.g.*, 34 FPC Annual Report 170 (1954). Plainly, the requested legislation has been directed only at seeking a reversal of the outcome in *Panhandle* and is not germane to the different question presented here.

in *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, had not established a "precedent for regulation of any part of production or *marketing*" (337 U.S. at 506; emphasis added). Evidently the Court regarded control over the sale of leases as inconsistent with its view that the Commission lacked direct authority over "production or marketing."[27] In *Phillips*, of course, the Court sanctioned an even more direct control over "production and marketing" by holding that the Commission, contrary to the assumption in *Panhandle*, had jurisdiction over an independent producer's interstate sale for resale.[28]

III. THE HOLDING BELOW WOULD UNDERMINE THE REGULATORY SCHEME BY CREATING A CLASS OF INDEPENDENT PRODUCER SALES FREE FROM EFFECTIVE REGULATION, EITHER STATE OR FEDERAL

If allowed to stand, the decision below would provide a simple mechanism for avoiding effective regulation, State or federal. As we have indicated (*supra*, pp. 5–6), the present arrangement was substituted for a conventional gas purchase agreement after the Third Circuit's decision in *Catco* made it apparent that producers' initial prices would henceforth be

[27] In defining the scope of "production or gathering" as precluding jurisdiction over "the transfer of undeveloped leases," the Court relied on the legislative history of H.R. 11662, 74th Cong., 2d Sess., and particularly the testimony of Mr. Dozier De Vane, then Solicitor of the Commission (337 U.S. at 505, n. 7), which the Court in *Phillips* expressly concluded had little relevance because it did not relate to the bill that finally was enacted into law. 347 U.S. at 682, n. 9.

[28] We also note the establishment of the principle that, once service has commenced from reserves underlying a sales contract, the producer cannot terminate that service without Com-

subject to careful scrutiny. This sale, involving reserves estimated at nearly a billion Mcf, is by no means an isolated example of attempts to use the device of an in-place sale to avoid effective Commission regulation of the price at which gas is purchased for the interstate market. Pan American Petroleum Company, for example, claims non-jurisdictional status for a similar arrangement with Tennessee Gas Transmission Company involving the sale of estimated reserves of about 750 million Mcf from the Bastian Bay field in Louisiana. See *Tennessee Gas Transmission Co.*, 30 FPC 1477, set aside in part *sub nom. Pan American Petroleum Corp.* v. *Federal Power Commission*, 339 F. 2d 694 (C.A. 10). Similarly the Catco companies sold gas reserves, estimated at more than 500 million Mcf, in the Ship Shoal field, offshore Louisiana, to Tennessee Gas Transmission Company under a lease sale agreement. See *supra*, p. 26.[20] And, as is apparent from our discussion of the sale involved in the case at bar (*supra*, pp. 20–28), the lease sale device could, without any real change in operation or in producer-pipeline relationships, become the dominant means of selling gas to natural gas pipelines.

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mission approval. *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389 (*Catco*), and *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission*, 364 U.S. 137, 156. It follows that once a producer has commenced service from any of the leases dedicated to a contract, even though some may not be developed, he can alienate those leaseholds only with Commission approval.

[20] The parties to another proposed lease sale agreement substituted a conventional sales agreement after the examiner had found that the lease sale was jurisdictional and had refused to issue a certificate for related facilities. See *Tennessee Gas Transmission Co.*, 29 FPC 4.

If such sales were not subject to direct Commission regulation, an "attractive" and, we apprehend, a rapidly widening "gap" in the regulatory system would be created; for here, as in *Lo-Vaca*, the producing State could not reasonably be expected to close a gap that woud permit "higher pipeline costs which ultimately would be reflected in rates paid by consumers in other States." *Lo-Vaca*, slip op. pp. 4-5; see, also, *Federal Power Commission* v. *Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1.

To be sure, the Commission would have power to examine these transactions in a proceeding to determine just and reasonable rates for the pipeline purchaser, and at that time—at least in theory—could disallow such portion of the leasehold acquisition costs as it found to be improvident. See, *e.g.*, *Southwestern Bell Telephone Co.* v. *Public Service Commission of Missouri*, 262 U.S. 276, 289; *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio*, 294 U.S. 63, 72. One may well question the practicalities of that remedy. How readily could the Commission establish, for example, that a pipeline purchaser had been improvident in the face of a claim by the pipeline that it had overestimated the reserves in an acquired tract? Could the Commission expect a pipeline, in purchasing a large block of reserves, to make the kind of investigation of producing costs and market conditions that the agency, with all of its investigatory powers, might undertake? And in this area, where the problems of price determination are of unrivaled complexity and the factors of judgment numerous, could any price, other than one well beyond the upper reaches of a broad zone of reasonableness, be

proved an improvident expense? The answers are more than doubtful. Indeed, it seems evident that if price regulation is to be effective, the burden of justifying the price must be placed upon the pipeline and its suppliers before the transaction is consummated. At that point, they should be called upon to produce information which will permit a reasonably accurate determination of the unit price and of its justness and reasonableness. See *Atlantic Refining Co. v. Public Service Commission of New York,* 360 U.S. 378, 392. A proceeding to establish that a course of business long pursued was initially improvident is a far more difficult undertaking and, by the same token, furnishes far less protection to the consumer.

In addition, we point out that while the risk that an acquisition will be found improvident falls in the first instance upon the pipeline's investors, the resulting impairment of the company's capital might well increase the cost of attracting investment in the future and the additional cost would have to be borne by the ratepayer. As the Commission concluded in its opinion (R. 976):

> * * * Control limited to approving the costs of the gas to the purchasing pipeline is, of course, not an effective way to regulate producer prices because in the large a pipeline must be allowed to pass on its purchased gas costs to the ultimate consumer or it cannot continue to discharge its public service responsibilities.[30]

[30] This inadequacy in the protection afforded consumers by the Commission's power to disallow, in a rate case, improvidently incurred expenses was one of the reasons for amending the Gas Act in 1942 to require certificate authorization prior to

Thus, the opportunity to disallow the improvident portion of outlays in determining a purchaser's rates is scarcely a substitute for the ability to pass directly upon a seller's rates. If it were, there would be no need for the Commission to regulate producer rates at all, for it could protect consumers simply by making appropriate adjustments in the pipeline's cost of service.

Nor is there any assurance that the Commission could effectively regulate these sales through the exercise of its power to certificate the construction of facilities necessary to transport the gas from the leaseholds. For, in many cases, the transfer might well be consummated, and the parties legally obligated, long before the pipeline seeks authority to build the needed facilities for transporting the gas.[31]

undertaking any new construction and acquisition of jurisdictional facilities or initiation of new service. 56 Stat. 83, 84. Prior to that time the Gas Act, as enacted in 1938, required certificate authorization only if a natural gas company proposed to provide service to an area already being served by another natural gas company. 52 Stat. 825.

This Court, in *Federal Power Commission* v. *Texaco Inc.*, 377 U.S. 33, recognized this in observing that protection of the consumer interests may frequently "be best achieved if it is done at the very threshold of the enterprise" (*id.* at 42), a fact also recognized by Congress in the legislative history of the 1942 amendments quoted in *Texaco* (*id.* at 43–44).

[31] In the present case, to be sure, the contract was contingent upon issuance by the Commission of a certificate for Texas Eastern's proposed facilities. However, the parties apparently considered the original certificate, which was subsequently set aside, as fulfilling that contract condition. In contrast, in the Bastian Bay and Ship Shoal transactions, *supra*, there was no provision making the conveyance dependent upon receipt of a certificate by the purchasing pipeline.

At that point—as in a rate case—the Commission would have the choice of saddling the consumer with unwarranted gas costs or of disallowing a portion of those costs at the risk of impairing the pipeline's financial status.

Moreover, even if the transaction were presented to the Commission at an executory stage, the interests of consumers would still not be adequately protected. It is questionable whether the Commission, in granting certificate authority to construct facilities, could insert a condition requiring periodic adjustment of the sale price in accordance with future determinations under Section 5 standards of justness and reasonableness, as it could if the transaction were deemed a continuing sale of "natural gas" in interstate commerce. For if the Commission were unable to consider directly the seller's costs and financial requirements in determining the prudence of an acquisition, "the existence of power to achieve the same end indirectly through the conditioning power might well be doubted * * *." *Sunray Mid-Continent Oil Co.* v. *Federal Power Commission,* 364 U.S. 137, 152.

CONCLUSION

For these reasons, the judgment of the court of appeals should be reversed and the orders of the Commission reinstated.[32]

Respectfully submitted.

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[32] If we are correct in our view that the transfer to Texas Eastern was a sale of gas subject to the Commission's jurisdiction, it is evident that the Commission properly refrained from issuing a certificate to Texas Eastern and that its orders should be affirmed. We note additionally that the Commission has preserved to Texas Eastern and the producers full opportunity to make the showing which it believes required in order to justify certification under Section 7 (R. 1229-1230).

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